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Christian H. Kälin and **Christian Rödl**
Henley & Partners, Zurich and Rödl & Partner, Nuremberg

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The End of Exit Taxes in Europe?

Christian H. Kälin and **Christian Rödl**
Henley & Partners, Zurich and Rödl & Partner, Nuremberg

The European Court of Justice rendered a judgment on March 11, 2004 concerning the exit tax which is imposed in France on holders of substantial participations who give up their residence and move abroad. The court ruled that the exit tax provisions of this kind restrict the freedom of movement (Article 43 of the EC Treaty). This decision will have a considerable impact on the current exit tax regimes in existence in various E.U. countries, for example, Germany or the Netherlands, and will probably even apply with regard to taxpayers moving to Switzerland, one of the most attractive locations for business and residence in Europe.

I. The de Lasteyrie du Saillant Decision

When Mr de Lasteyrie du Saillant, a French tax resident, decided to move his residence from France to Belgium in September 1998, he was caught by a provision in the French General Tax Code[1] which allows the tax authorities to assess capital gains on the unrealised increase in value of securities held by businesses or individuals moving their tax residence out of France. Mr de Lasteyrie du Saillant appealed to the *Conseil d'Etat*, the highest administrative court in France, which in turn asked the Court of Justice of the European Communities (European Court of Justice, ECJ) whether the French exit tax provisions, which provide for taxation of increases in value only when tax residence is moved outside of France, may violate the principle of freedom of establishment guaranteed by Article 43 of the EC Treaty. The ECJ rendered a judgment on March 11, 2004[2] and found that:

> "the principle of freedom of establishment laid down by Article 52 of the EC Treaty (now, after amendment, Article 43 EC) must be interpreted as precluding a Member State from establishing, in order to prevent a risk of tax avoidance, a mechanism for taxing as yet unrealised increases in value such as that laid down by Article 167a of the French Code *Général des Impôts*, where a taxpayer transfers his tax residence outside that State".

This remarkable decision will have an important impact on the continued existence of exit taxes provided for in the legislation of many other E.U. countries, and arguably also applies with regard to taxpayers moving to Switzerland.

The French rules are generally less restrictive than the rules existing in some other E.U. countries. In particular, the French provisions are by far less restrictive than the exit taxes in Germany since they only target anti-avoidance cases (in particular relocation to the foreign country with the objective to alienate the shares under a favourable tax regime and subsequent move back to France). Therefore, the considerably more extensive German regime must also be considered a violation of E.U. Law.

II. Germany

If an individual, who has been subject to unlimited tax liability for at least 10 years, relocates his tax residence out of Germany to a foreign country and if this person holds 1 percent or more of the shares in a German corporate entity (*e.g.,* GmbH or AG), German law provides for a deemed sale of such shares.[3] The fictitious capital gain, which will be taxed, is basically the difference between the fair market value upon expatriation and the acquisition costs of the shares in the past. As a consequence, 50 percent of the capital gains are subject to the individual tax rate of the moving shareholder. The qualification as deemed sale does not require that the shareholder moves to a country with low tax rates. The same applies to a shareholder who did not move to a foreign country himself, but who transfers the shares in the German corporate entity gratuitously to a person living in a foreign country, for example, to his wife or children. Personally or professionally motivated moves to the United States, France, Austria or another high-tax country could therefore trigger the German Expatriation Tax under section 6 Foreign Relations Tax Act. In the light of the *de Lasteyrie du Saillant* decision, these provisions are clearly in violation of EC law.

The European Commission has therefore demanded that Germany abolishes section 6 of its Foreign Relations Tax Act or modifies it in a way that is compliant with E.U. law. Although Germany rejected the Commissions demand, the vast majority of German tax lawyers are of the view that the German Expatriation Tax violates European law. Everyone who intends to leave Germany or to transfer his shares (partly or completely) without payment, for example, to his children living abroad, should consider pursuing his plans now, *i.e.,* without taxation of the built-in gains in the shares following the ECJ's decision.

Germany may now modify its existing legislation thereby giving Germany the right to assess the built-in gains upon the shareholder's move, "freeze" them and tax this fictitious capital gain later on when the shares are effectively sold – but not any earlier. The same applies for other E.U. Member States that have similar exit taxes. However, such unilateral provisions are also subject to existing Double Taxation Conventions (DTC). In most cases, the move abroad results in the shifting of the right to tax the capital gains in the shares from one country (which the shareholder leaves) to the new host country; except in certain cases where DTCs prescribe special rules for real estate companies. Therefore, the subsequent taxation of the "frozen" capital gains which have been accrued before the move abroad, could not be realised by, for example, Germany because it does not have the right to impose taxes on these capital gains according to the respective DTC. Germany could, however, avoid this "taxation gap" by modifying its Double Taxation Conventions. Each German DTC would need to be renegotiated and modified. This requires a significant amount of time. Until such time the individual taxpayers have the opportunity to take their shares in German corporate entities with them when moving abroad. A later sale will then be subject exclusively to the tax regime of the new host country.

An additional consequence of the *de Lasteyrie du Saillant* decision with regard to Germany relates to the relocation of corporate entities. German tax law still provides for the deemed liquidation of the moving corporate entity[4] which most likely also violates E.U. Law as the ECJ understands it in its reasoning. So far, the ECJ's 1988 *Daily Mail*[5] decision is overruled. Even cross-border mergers are covered by the *de Lasteyrie du Saillant* decision if they lead to taxable gains. Such mergers are not covered in the European Merger Directive.

Another provision of the German tax law[6] prescribes that built-in gains in assets which are transferred from business property in one country to business property in a foreign country are taxed unless the capital gain taxation of such assets is guaranteed in Germany in cases where the sale of such assets take place at a later date. These rules also violate prevailing European law.

III. The Netherlands

In the Netherlands, exit taxes are also levied in cases where an individual taxpayer who is a substantial shareholder or who is self-employed, or a corporate taxpayer moves away from the Netherlands to another country. However, the Dutch rules with regard to exit charges for substantial shareholders are somewhat less restrictive than the French ones, as the Netherlands allows suspension of payment on the provision of a guarantee. By contrast, in France a substantial shareholder who moves abroad has to designate a fiscal representative in France and is obliged to file an income tax return every year.

In the case where a substantial shareholder moves abroad from the Netherlands, income tax will be payable on the difference between the market value of the shares at the time of the change of residence less the cost of acquisition. It is possible to postpone payment if a guarantee is provided.

However, no postponement is possible if a self-employed individual changes his residence from the Netherlands to another country and moves away with his business. In this case, the self-employed individual is considered to have sold at market value the assets that he is taking abroad, and consequently is taxed for the (unrealised) capital gains.[7] Similar rules apply in the case where a Dutch company migrates from the Netherlands.[8]

The Dutch government is of the opinion that the requirement of a guarantee to obtain a suspension of payment of the Dutch exit charges which are due on the holdings of substantial shareholders who move abroad violates the principle of freedom as provided for in Article 52 of the EC Treaty,[9] in cases where they move to another E.U. or EEA country. However, in the case of migration to a country outside the European Union or the EEA, substantial shareholders will still be required to either pay or provide a guarantee.

IV. Other European Countries and Switzerland

Except for the new E.U. Member States, most E.U. countries have some form of exit tax provisions; be it for companies or for individuals/self-employed persons, or both. These exit taxes are, in their current form, in violation of EC law. As mentioned above, those E.U. countries will now have to either abolish or change their exit tax provisions in a way that may well result in the government's right to assess unrealised capital gains upon the shareholder's move and to charge tax later on, if and when the shares are eventually sold. With regard to collection of tax claims, E.U. countries can take recourse to the EC Mutual Assistance Recovery Directive.[10]

Switzerland, which is neither a member of the European Union nor likely to become a member in the foreseeable future, is a very attractive country in terms of personal and corporate taxation. It generally does not tax private capital gains.[11] It is therefore important to know whether European law and the *de Lasteyrie du Saillant* decision apply to migrations from E.U. countries to Switzerland. This question has been widely discussed. However, we are convinced that the affirmative answer is correct because the association treaties (Bilateral Treaties I and II) between the E.U. countries and Switzerland clearly guarantee the free movement of persons, and also in view of the non-discrimination clauses in DTCs of individual E.U. Member States and Switzerland, for example, in the DTC between Germany and Switzerland. It is also generally accepted that the free movement of capital guaranteed by the EC Treaty also applies in relation to third countries. At a recent meeting of the Swiss and German section of the International Fiscal Association,[12] the general opinion pointed in the same direction.

In conclusion, the *de Lasteyrie du Saillant* decision of the ECJ is having a considerable impact on the various exit tax regimes in existence in Europe, and it opens up very attractive planning opportunities for companies as well as private clients and entrepreneurs resident in E.U. countries and wishing to re-locate to Switzerland and other countries. In particular, the new E.U. Member States offer a more attractive tax environment than some of the larger European countries.

1 Article 167a of the *Code Général des Impôts*

2 *Hughes de Lasteyrie du Saillant vs. Ministere de l'Economie, des Finances et de l'Industrie*, ECJ No. C-9/02, 3/11/04

3 Section 6 Foreign Relations Tax Act (*Außensteuergesetz*)

4 Section 12 of the German Corporate Income Tax Act

5 ECJ, No. 81/87, 27/09/88

6 Section 6 Para. 5, sentence 1 of the German Income Tax Act

7 Articles 3.60 and 3.61 of the Dutch Income Tax Act

8 Articles 15c and 15d of the Dutch Corporation Tax Act

9 Answer of 13 April 2004 by the Dutch Deputy Minister of Finance to a question in the Dutch Parliament

10 EC Council Directive 76/308/EEC, as amended by Council Directive 2001/44/EC.

11 Article 16 (3) Federal Direct Tax Act (*Bundesgesetz über die direkte Bundessteuer, DBG*) and Article 7 (4) Federal Tax Harmonisation Act (*Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden, StHG*)

12 See *Tagungsbericht Gemeinsame Arbeitstagung der Schweizerischen und Deutschen Landesgruppe der IFA*, Frankfurt, June 2004.

Christian H. Kälin *is an international tax, estate planning and real estate specialist and a partner at Henley & Partners, Zurich/Switzerland (www.henleyglobal.com).*

Dr. Christian Rödl *is an international tax specialist, managing partner and head of service line corporate and tax law at Rödl & Partner, Nuremberg/Germany (www.roedl.de).*